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BDO KNOWS: COMPENSATION AND BENEFITS

SUBJECT

NEWLY PROPOSED SECTION 457(F) REGULATIONS PROVIDE PLAN DESIGN OPPORTUNITIES FOR TAX-EXEMPT EMPLOYERS

SUMMARY

Recently, the IRS released proposed regulations that provide guidance for the nonqualified deferred compensation arrangements of tax-exempt organizations (as well as state or local governments). These long-awaited rules address the interplay between Section 457 and Section 409A governing the nonqualified deferred compensation arrangements of *all* employers (including tax-exempts). The newly proposed Section 457 regulations provide plan design opportunities for tax-exempt employers.

Tax-exempt and governmental employers should review their deferred compensation arrangements, severance plans, and welfare benefit plans in light of these proposed regulations, and consider plan design changes that enhance their objectives within the confines of these rules.

The proposed regulations become effective upon finalization, but may be relied upon in the meantime.

DETAILS

There are several plan design opportunities included in the proposed regulations. Section 457(f) requires the immediate taxation of nonqualified deferred compensation upon vesting. Its newly proposed regulations contain plan design features that effectively delay the vesting event, thereby avoiding immediate taxation under Section 457(f).

- **Rolling Risk of Forfeiture:** The proposed regulations permit an upcoming vesting date (and the point of taxation) to be extended, provided: (i) the extension is made at least 90 days before the vesting date; (ii) the extended vesting is conditioned upon the employee's provision of

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substantial services for at least two years (absent an intervening event such as death, disability, or involuntary severance from employment); and (iii) the present value of the amount to be paid at vesting must be more than 125% of the amount the employee otherwise would have received in absence of the extended vesting date.

BDO Insight: Section 409A similarly disregards an extended risk of forfeiture, unless the present value of the deferral is *materially greater* than the amount otherwise payable absent such extension. However, Section 409A does not provide a bright line test to determine "materially greater" and does not require a two-year, service-based minimum extension. The Section 457 proposed regulations are more rigid with respect to tax-exempt employers. Where an employer is exempt from US taxation, the employee derives a tax benefit from the deferral while the employer is indifferent. The additional payout required under the Section 457 proposed regulations is designed to constrain tax-motivated deferrals by employees. A tax-exempt employer may not be as willing to agree to the additional vesting period if the payout is significantly higher (e.g., pay the employee $100,000 in 2018 or more than $125,000 in 2020).

- **Salary Deferrals:** Under prior guidance, current compensation (e.g., salary, commissions, and certain bonuses) was considered vested and therefore ineligible for deferral under Section 457(f). However, the proposed regulations permit current compensation to be deferred under Section 457(f), provided the following rules are met: (i) the deferral election must be made in writing before the beginning of the calendar year in which any services that give rise to the compensation are performed (or within 30 days after a new employee's hire date for pay attributable to services rendered after the deferral election), (ii) payment of the deferred amounts must be conditioned upon the employee's substantial services for at least two years (absent an applicable intervening event), and (iii) the present value of the amount to be paid at vesting must be more than 125% of the amount the employee otherwise would have received in absence of the deferral.

  BDO Insight: The two-year minimum deferral period applies separately to each payroll deferral. Also, an employer match of more than 25% may be required to satisfy the 125% rule for salary deferrals.

- **Noncompete Agreements:** Under prior guidance, the vesting schedule for deferred compensation served as a retention mechanism, requiring the employee's continuous services through the vesting date as a condition to receive the amount. Under the newly proposed regulations, vesting may also serve as an enforcement mechanism for a noncompete covenant, requiring an employee to refrain from providing services to a competitor for a specified period. Provided the noncompete is a written, bona fide, and enforceable covenant, the vesting period may be extended through the end of the restrictive period, allowing tax-exempt employers to make post-employment payments during such period. In addition, deferred compensation payable upon a voluntary termination is no longer treated as fully-vested at all times if the amounts could be forfeited in accordance with the terms of a bona fide noncompete covenant.

  BDO Insight: Among other factors applied to determine a bona fide noncompete covenant, the facts and circumstances must show that the employer has a substantial interest in preventing the employee from performing the prohibited services. To the extent the compensation paid to the employee for entering into a noncompete agreement exceeds the value of such agreement (measured, for example, by the economic damages the organization would incur from an employee's violation of that covenant), then the restrictive covenant may not be a bona fide noncompete agreement for purposes of Section 457. A valuation of the noncompete agreement may be in order to support an extension of the vesting date to the end of the restrictive period.

- **Short-Term Deferrals:** The proposed regulations provide that Section 457(f) does not apply to an arrangement in which payment is made within the "2 ½ month short-term deferral period" under Section 409A (generally, March 15 of the first calendar year following the year of vesting).

  BDO Insight: The Section 457 proposed regulations apply the Section 409A definition of short-term deferral, but substitute its own definition for "substantial risk of forfeiture." Accordingly, a short-term deferral under Section 457 may not constitute a short-term deferral under Section 409A (as in the case of a plan with a noncompete vesting provision). Technically, income taxes are due upon vesting under Section 457(f). However, the proposed regulations make clear that short-term deferrals are not subject to Section 457(f), thereby allowing income taxes to be collected upon distribution, which is administratively convenient where there is a gap between the vesting and distribution dates.

- **Severance Pay:** The proposed regulations provide that Section 457(f) does not apply to severance pay in connection with an involuntary separation from service (including a voluntary termination by the employee for a pre-established, good reason condition that has not been remedied by the employer) or pursuant to a window program or an early retirement incentive plan. Payments under such “bona fide severance pay plans” must not exceed two times the employee’s annualized compensation for the preceding calendar year (or the current calendar year if the employee had no compensation from the employer in the preceding year) and payment must be made by the last day of the second calendar year following the calendar year in which the severance occurs.

  BDO Insight: Pay due to an involuntary separation from service or participation in a window program is similarly exempt from Section 409A in limited amounts (the lesser of two times the employee’s annual rate of pay for the preceding year or two times the compensation limit set forth under Section 401(a)(17) for the year of separation).

- **Other Welfare Plans:** The proposed regulations clarify that Section 457(f) does not apply to bona fide death benefit, disability pay, sick leave, and vacation leave plans.

  BDO Insight: Section 409A similarly exempts such welfare plans from its deferred compensation rules.

ADDITIONAL PROVISIONS

The proposed regulations also confirm that Section 457(f) applies separately and in addition to Section 409A, address recurring part-year compensation for educational institutions, provide methods to calculate the present value of deferred compensation (which are similar to the rules set forth in the existing Section 409A proposed regulations), and reflect other statutory changes impacting Section 457 since the publication of its final regulations in 2003.